November 12, 2014

Via Electronic Submission

Chris Kirkpatrick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Position Limits for Derivatives (RIN Number 3038-AD99)

Dear Mr. Kirkpatrick:

The Electric Power Supply Association ("EPSA") respectfully submits these comments in response to the specific proposal of the Commodity Futures Trading Commission ("CFTC") in the Notice of Proposed Rulemaking on Position Limits for Derivatives[1] ("Proposed Rule") to limit the qualification of certain cross-commodity hedges as *bona fide* hedging positions.

EPSA is the national trade association representing leading competitive power suppliers, including generators and marketers. These suppliers, who account for nearly 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers.[2]

EPSA members are physical commodity market participants that rely on commodity derivative contracts primarily to hedge and mitigate their commercial risk. Accordingly, EPSA urges the Commission to adopt a definition of *bona fide* hedging that is easily understandable and commercially practicable by incorporating the specific recommendations described below.

On December 12, 2013 the Commission published a Proposed Rule to establish speculative position limits for 28 exempt and agricultural commodity futures and option contracts and physical commodity swaps that are "economically equivalent" to such contracts. Comments on the Proposed Rule were due February 10, 2014. EPSA, jointly with the Edison Electric Institute ("EEI"), filed comments in response to the Proposed Rule. On May 29, 2014, the Commission announced that Commission staff would host a public roundtable to discuss and consider certain issues related to the Proposed Rule regarding position limits for physical commodity derivatives ("Public Roundtable"), to take place on June 19, 2014. In connection

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1 Position Limits for Derivatives, 78 Fed. Reg. 75,680 (Dec. 12, 2013).

2 The comments contained in this correspondence represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

with the Public Roundtable, the Commission announced it would allow comments on the Proposed Rule related to discussions at the Public Roundtable for a period of three weeks starting on June 12, 2014 and ending on July 3, 2014. On July 3, 2014, the Commission published an extension of the comment period until August 4, 2014.[3] EPSA filed comments in response to the discussion at the Public Roundtable on this issue on August 4, 2014.

The Proposed Rule would permit certain cross-commodity hedges to qualify as *bona fide* hedging positions, "provided that the fluctuations in value of the position in the commodity derivative contract, or the commodity underlying the commodity derivative contract, are *substantially related* to the fluctuations in value of the actual or anticipated cash position or pass-through swap and no such position is maintained in any physical-delivery commodity derivative contract during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract."[4] To further elaborate on when a cross-commodity hedge would be considered "substantially related" to a cash-market position, the Commission provided a non-exclusive safe harbor based on two factors: (1) a qualitative factor, requiring a reasonable commercial relationship between the underlying cash commodity and the commodity underlying the commodity derivative contract; and (2) a quantitative factor, requiring a reasonable and measureable correlation in light of available liquid commodity derivative contracts. Under the Proposed Rule, the CFTC would only presume an appropriate quantitative relationship "when the correlation, between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract is at least 0.80 for a time period of at least 36 months."[5] Positions that do not satisfy *both* the conditions of the safe harbor are presumed *not* to be *bona fide* hedging positions; however, a person may attempt to rebut this presumption.[6]

If the Commission adopts a Final Rule that is too narrow or inflexible, including an unworkable definition of *bona fide* hedging, it will make important hedging activities more difficult for commercial end users which, as a consequence, will likely increase the volatility and price of energy for residential, commercial, and industrial customers. EPSA again urges the Commission to reconsider the quantitative factor in the proposed safe harbor. In many cases, a quantitative test of correlation based on spot month prices is an unsuitable method of assessing whether a hedge is appropriate because it does not accurately reflect how prices converge across the forward curve. For this reason, many market participants assess and manage their forward price risk using customized analytical models that take into account the characteristics of their particular markets. The Commission should not attempt to reduce this complex, and often subjective, process to a crude mathematical formula which would, in many cases, yield a result

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[3] 79 Fed. Reg. 37973 (July 3, 2014).

[4] *Id.* at 75,824 (emphasis added).

[5] *Id.* at 75,717.

[6] *Id.*

that is incorrect. Rather than defining when a hedge is "substantially related" to the price of an underlying commodity using an arbitrary numeric threshold measured over an arbitrary period of time, the CFTC should permit market participants to make commercially reasonable determinations of which contracts are substantially related.

Utilities and other power generators have long used natural gas Referenced Contracts to hedge the price risk associated with their electricity production. This hedging activity is a successful risk-management practice that has been employed for decades based upon EPSA members' commercial experience and reasonable business judgment. EPSA members have risk management processes in place to measure and monitor hedge effectiveness, including the effectiveness of cross-commodity hedges. It is the job of those responsible for hedging to maintain effective hedges, and if the effectiveness of a cross commodity hedge slips, sound risk management demands that the hedge be adjusted. The Commission should not substitute an unproven numeric threshold for the experience, judgment, and sound risk management practices of EPSA members and other commodity end-users.

EPSA disagrees with the Commission statement that fluctuations in the value of electricity contracts typically will not be substantially related to fluctuations in the value of natural gas.[7] The Commission's stated belief about the lack of a substantial relation between power and natural gas prices is incorrect as there is substantial evidence in the assessments done by the Federal Energy Regulatory Commission as well as the system operators responsible for maintaining reliability in the electricity markets about the correlation between electricity contracts and natural gas contracts.[8] According to the Energy Information Administration ("EIA"), natural gas comprised 15.8 percent of the fuel mix for electric generation in 2000 and 30.7 percent of the fuel mix for electric generation in 2012. Due to retirements of coal-fired generation in response to EPA rules and low natural gas prices this trend is likely to continue going forward. This connection between natural gas prices and electricity markets is illustrated in the State of the Market Report prepared by the NYISO independent market monitor: "Average electricity prices fell 16 to 25 percent from 2011 to 2012, which was primarily due to lower natural gas prices. Natural gas prices fell 28 to 35 percent over the same period. … *The*

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7 *Id.*

8 See *e.g.* Winter 2013 -14 Energy Market Assessment, FERC Staff Report to the Commission (slide 11 illustrates correlation between natural gas and electricity prices in New England), Docket No AD06-3 (October 2013); 2013 Special Reliability Assessment: Accommodating an Increased Dependence on Natural Gas for Electric Power, http://www.nerc.com/pa/RAPA/ra/Reliability%20Assessments%20DL/NERC_PhaseII_FINAL.pdf; Coordination Between Natural Gas and Electricity Markets , Docket No. AD12-12 FERC Staff Quarterly Reports, http://www.ferc.gov/legal/staff-reports/2013/A-4-presentation.pdf;; Potomac Economics 2012 State of the Market Report for the ERCOT Wholesale Electricity Markets, http://www.potomaceconomics.com/uploads/ercot_reports/2012_ERCOT_SOM_REPORT.pdf; ISO New England 2013 Regional Electricity Outlook, http://www.iso-ne.com/aboutiso/fin/annl_reports/2000/2013_reo.pdf;

correlation between energy and natural gas prices is expected in a well-functioning, competitive market because natural gas-fired resources were the marginal source of supply in 80 percent of the intervals in New York in 2012." This inter-relationship will only increase as natural gas is increasingly used for electric generation and displaces baseload units such as nuclear and coal while still being used as peaking units and to back-up renewable generation such as solar and wind.[9] In fact, electricity prices and natural gas prices are so interrelated that the FERC recently initiated a rulemaking process[10] and an administrative docket to evaluate the correlation between the two markets and direct the natural gas markets and the electricity markets to work together to ensure greater coordination between the two markets.[11]

There are also other significant problems with the Commission's proposed limitations on cross-commodity hedges. First, using spot prices to make this determination, as proposed by the CFTC, is inconsistent with actual market practice. Many market participants hedge long-term electricity price exposure with natural gas derivatives contracts because there is insufficient liquidity in deferred month electricity derivatives contracts. In that case, a market participant will often convert its hedges from gas derivatives to electricity derivatives as the risk moves closer to, or into, the spot month. The inconsistency of requiring the proposed correlation for outer month hedges based on a quantitative test that looks at spot month prices, could eliminate all available tools for hedging at illiquid electricity locations for which natural gas is often the best or only available hedging product. The elimination of hedging alternatives will result in higher risks for market participants and higher costs for consumers. As a result, the Proposed Rule would impermissibly and inappropriately limit a necessary, well-established, and beneficial hedging practice.

While EPSA recognizes the Commission's attempt to develop a bright-line test for what qualifies as a *bona fide* hedging position, EPSA is concerned that the Commission will reduce a complex, and often subjective, process to a flawed mathematical formula which will have unintended consequences and inappropriately eliminate the best available hedge. Due to the close relationship between natural gas and electricity, EPSA again requests that the Commission modify the safe harbor provision to require compliance with the qualitative component only and that the Commission remove all statements about a general lack of correlation between electricity and natural gas.

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9 Annual State of the Market Report by the NYISO Independent Market Monitor for 2012, Executive Summary page 1. (Emphasis added).

10 *Coordination of the Scheduling Processes of Interstate Natural Gas Pipelines and Public Utilities*, 79 Fed. Reg. 18,223 (April 1, 2014).

11 *Winter 2013-2014 Operations and Market Performance in Regional Transmission Organization and Independent System Operators*, Docket No. AD14-8-000.

EPSA appreciates the Commission's consideration of our comments regarding the proposed treatment and calculation of *bona fide* hedging positions under the proposed Position Limits rules. We are happy to discuss our comments further. Please feel free to contact EPSA if you have any questions regarding these comments.

Respectfully submitted,

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cc: Chairman Massad
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